ECONOMIC GOVERNANCE AND ITS IMPORTANCE FOR USAID/LAC'S WHITE PAPER ON RURAL PROSPERITY

Prepared by

Clarence Zuvekas, Jr.
Consultant
Chemonics International Inc.
Washington, D.C.

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CONTENTS

I. BACKGROUND

This paper is a contribution to a Rural Prosperity White Paper being prepared by the Bureau for Latin America and the Caribbean (LAC) of the U.S. Agency for International Development (USAID). The White Paper seeks to provide "a framework with guidelines for reference in developing strategic approaches, programs, and activities to promote rural prosperity and reduce poverty in the LAC region and to guide [the] LAC Bureau as it links with the other parts of the Agency and its partners" (from the draft outline).

The White Paper responds in part to the new USAID Administrator's initiative to re-emphasize, after years of neglect by the international donor community, the significant potential of the agricultural sector for reducing poverty, hunger, and conflict. At the same time, it adopts a broad, rural-economy approach that considers non-farm as well as farm-based sources of livelihood. This comprehensive vision is appropriate, first, because the combined "food and agroindustrial system" generates close to four times the value of agriculture defined as farm-based production (Bathrick 2001:3, citing a study by the International Food Policy Research Institute [IFPRI]).[1] Second, other sectors, such as tourism and *maquila* (assembly) production, also offer significant potential for generating income and employment in the rural areas of many LAC countries. In some LAC countries, emigrants' remittances (as well as the oft-neglected internal, intrafamilial transfers from urban to rural areas) also contribute importantly to rural livelihoods; but these flows are not directly influenced by USAID strategies, programs, and activities.

Notwithstanding these important nonagricultural sources of rural incomes, the overall performance of the rural economy in most if not all of the LAC countries assisted by USAID will depend primarily on the health of the agricultural sector (de Janvry and Sadoulet 2001:10). Faster agricultural growth will generate increases in rural non-farm incomes and employment through effects that are both direct (backward and forward linkages) and indirect (generalized spending on goods and services by farm households). Many of these goods and services, including agricultural inputs and services, can be produced in rural areas, often by micro and small businesses.

The White Paper is based on a strategic approach centered on trade-led economic growth. Its four action areas are: (1) rules of trade and market access, (2) science and technology, (3) access to assets, and (4) vulnerability management. As a cross-cutting theme, improved economic governance is deemed necessary "to more fully integrate [the] poor and disadvantaged into [the] economy, reducing poverty and conflict and expanding democratic participation" (from the draft outline).

It is important to bear in mind that a strategic approach seeking to promote rural prosperity and reduce rural poverty must have a long-run focus. There are no quick fixes, especially since wealth redistribution offers much less hope for improving livelihoods

[1] A more recent paper by IFPRI's Director General (Pinstrup-Andersen and Babinard 2001:10) repeats this figure, but also notes that while agriculture accounts for 10% of LAC's GDP, agriculture plus agro-industry account for 25% (p. 2). The higher, 4:1 ratio presumably includes multiplier effects on other economic sectors.

than wealth creation. Rapid economic growth, sustained over several decades, is the best way to achieve significant reductions in poverty; but growth policies need to be complemented by public and private actions to increase the assets of the rural poor.

The next section of this paper discusses several alternative definitions of the concept of economic governance. Subsequent sections focus on the interrelationships among economic governance, democracy, economic growth, poverty, and conflict; the linkages between economic governance and the action areas identified above; the respective roles of the public and private sectors in economic governance; appropriate and inappropriate interventions for improving economic governance; and program and operational linkages within USAID and between USAID and other development institutions.

II. THE CONCEPT OF ECONOMIC GOVERNANCE

Most economists have discovered "good governance" as a major determinant of economic growth only in the last 10-15 years. A few, like Nobel laureate Douglass North, had been stressing its importance well before then, even though their focus was more explicitly on "institutions." Governance may be defined succinctly as "the traditions and institutions that determine how authority is exercised in a particular country" (Kaufmann, Kraay, and Zoido-Lobatón 2000:10).

The term "economic governance" is of more recent vintage, and it remains a concept in search of a clear and widely accepted definition. A quick look at a number of papers on this topic available on the Internet (not including the many dealing with *international* economic governance) reveals that authors are reluctant to define the concept and tend to concentrate on narrow aspects of economic governance (e.g. property rights, contracts, regulatory functions, corruption, fiscal management, or overall macroeconomic policy). Much of the economics literature is highly theoretical and mathematical, as exemplified by a recent paper by Dixit (2001), who, helpfully or not, tells us that "almost all economic transactions need governance" (p. 2).

USAID/LAC's recent paper on "Rethinking the Rural Economy in LAC" (USAID 2001:5, footnote 1) defines economic governance as:

> the enabling environment within which the economy functions[; it] implies the need to ensure stable, transparent and predictable rules and regulations that encourage competition and equitable access to public services. Economic governance is achieved through a country's public *and* private sector institutions that exert a determining or guiding influence in or over how individuals, enterprises, and/or countries carry out economic transactions.

The LAC paper also characterizes economic governance as "the essential governance functions that facilitate trade and that expand participation in markets" (p. 5).

The LAC definition, which can be considered to fall within the Northian tradition, highlights the key characteristics of stability, transparency, and predictability, and importantly encompasses private as well as public institutions. Its perspective is primarily microeconomic, although a macroeconomic dimension is implicit in the consideration of "how . . . countries carry out economic transactions," and USAID/LAC has made clear that its intention was indeed to cover macroeconomic as well as microeconomic policies.

Another definition of economic governance, presented by an advisor to USAID/LAC, considers it as a "concept . . . [that] refers to those parts of a country's public sector and private sector institutional infrastructure that exert a determining or guiding influence in or over how individuals, enterprises (businesses), and/or countries carry out economic (broadly) and commercial (narrowly) transactions" (Byrnes 2001:38). For the public sector, the "institutional infrastructure" is said to comprise (1) **policies** (including laws and regulations) that influence economic, financial, and commercial transactions; (2) the **organizations** through which policies are implemented; and (3) the **tools** (procedures, practices, and technologies) used to formulate, implement, and evaluate policies. Again the focus is primarily on microeconomic policies, with macroeconomic policies included as well by implication.

Byrnes identifies the private-sector dimensions of economic governance as voluntary industry agreements to set standards (e.g. for environmental certification). This definition could be expanded to cover other private-sector actions, including efforts to improve workers' capacities; the establishment of non-governmental organizations (NGOs) to promote microenterprise development; and joint activities with the public sector to promote and stimulate tourism, commodity exports and foreign investment.

This paper argues that a more comprehensive concept of economic governance should guide strategic thinking about rural prosperity. Macroeconomic policy, for example, deserves more explicit attention for two basic reasons:[2]

* Numerous quantitative studies have produced widespread agreement that economic growth, for which sound macroeconomic policy is crucial, is the most important means for reducing poverty over the long run (see, e.g. Dollar and Kraay 2001 and World Bank 2001, and the references therein).

* Incentives for agricultural production, the growth of which is crucial for reducing overall rural poverty, are affected more by macroeconomic policies (especially exchange-rate and trade policies) than by direct policies specifically affecting the agricultural sector (Krueger, Schiff, and Valdés 1988).

In addition, the concept of economic governance should give more emphasis to the regulatory functions of government, particularly in the financial sector and in situations of market failure (e.g. those that result in environmental damage) and of market-size

[2] Since the case for macroeconomic policy reform is well known, the White Paper does not need to include a detailed discussion of specific macroeconomic-policy interventions.

limitations that preclude the establishment of a sufficient number of firms to ensure competitive behavior.

Another important area of economic governance comprises public- and private-sector actions to reduce corrupt practices and other types of criminal activity against persons or property, all of which add to business costs--thus reducing competitiveness--and deter new investment.

Yet another area of economic governance consists of policies that determine the allocation of expenditures on physical infrastructure (especially roads, electric power, and irrigation) and services such as agricultural research and extension. Decisions in these areas have important effects of how broad-based the process of rural development will be.

Finally, the concept of economic governance should also encompass public-sector social policy, as well as private-sector actions to promote social development. Particularly relevant are activities that have a direct bearing on the formation of human capital--a key asset needed by the rural poor to escape from poverty. Public and private programs in education, workforce training, health, and nutrition are especially important in this respect.

This paper will not discuss specific macroeconomic policies, mainly because of time and space considerations and also because these policy areas have received a great deal of attention elsewhere. However, the other aspects of economic governance discussed above will be addressed briefly, although no attempt will be made to provide a concise, alternative definition of economic governance.

III. INTERRELATIONSHIPS AMONG ECONOMIC GOVERNANCE, DEMOCRACY, ECONOMIC GROWTH, POVERTY, AND CONFLICT

The interrelationships among economic and political variables in the process of development are complex and not subject to neat generalizations. The voluminous literature on the relationship between economic growth and democracy has produced ambiguous results--partly, one would guess, because democracy is often defined in too simple a fashion that does not allow for gradations of achievement in the various dimensions of democratic development. Likewise, strong economic growth is no guarantee that conflict will be avoided, as is clear from the examples of Iran and several Central American countries in the 1960s and 1970s.

Although the adoption of political democracy, especially in the narrow sense of electoral processes, does not automatically produce faster economic growth, a quantitative analysis of eight Latin American countries concludes, encouragingly and somewhat contrary to popular belief, that "competitive elections have enhanced, rather than undermined, the capacity of political leaders to address outstanding problems of macroeconomic management" (Remmer 1993:393).

While the relationship between economic governance (broadly defined to include macroeconomic policy) and economic performance seems to be strong (Kaufmann, Kraay, and Zoido-Lobatón 2000), that between one key element of economic governance--openness to trade--and economic growth is less clear. Even distinguished economists who are strongly in favor of trade liberalization (e.g. Jadgish Bhagwati and T.N. Srinivasan) have criticized the methodology of econometric studies purporting to show that greater openness accelerates GDP growth (The Economist 2001:10-11). Still, they would agree that much noneconometric evidence strongly suggests that trade is good for economic growth.

If economic growth is a (or the) major factor contributing to poverty reduction, as is widely accepted, and if economic growth is positively correlated with the quality of economic governance, as likewise seems clear, it follows that good economic governance does more to reduce poverty than poor economic governance.

The relationships between economic growth and poverty reduction, while strong, are nevertheless not as close as one might imagine. For example, poverty reduction for a given long-term growth rate of per capita GDP seems to be less in countries with highly unequal distributions of income (such as most Latin American countries) than in those where inequality is less (de Janvry and Sadoulet 2001:7; Wodon 2000:41). Similarly, a study prepared for USAID in 1997 by Peter Timmer found that agricultural growth was pro-poor in countries where income equality was modest, but not in countries with highly unequal income distributions.

For this reason, elements of economic governance not related to macroeconomic policy, or to the provision of general incentives to private investors, assume particular importance. For example, economic governance needs to focus on improving the access of the poor to assets (factors of production), markets, and information. Perhaps the most important of the assets is human capital, which is why the concept of economic governance needs to include social policy. Birdsall, Ross, and Sabot (1995) provide an insightful analysis, in the East Asian context, of the mutually reinforcing relationships among economic growth, education, poverty reduction, and narrower income disparities.

This section concludes by presenting a half-dozen illustrative examples of economic-governance actions in another area--the broad realm of participatory democracy—that also have the potential to strengthen economic-growth performance (Zuvekas 2000:60-61). These actions are:

* enacting legal reforms and ensuring an improved administration of justice, which strengthen property rights, lower the costs of dispute settlement, and reduce the likelihood of arbitrary applications of the law;

* undertaking measures to reduce criminal activity, which causes businesses to make significant investments in security systems and services and to raise risk premiums required as part of profit margins;

* decentralizing some government programs, ideally by transferring financial as well as administrative authority;

* providing greater scope for non-governmental organizations (NGOs) to administer social-service and environmental programs, and for other civil-society groups to play watchdog roles;

* making more rapid movement toward both legal and especially de facto equality of opportunity for women and minority groups; and

* permitting greater freedom of association, to allow various groups a reasonably equal opportunity to negotiate for economic, social, and cultural objectives in the political arena and the workplace.

Note that a number of these actions imply shared responsibility between the public and private sectors, a topic that will be examined in more detail in Section V below.

IV. INTERRELATIONSHIPS WITH WHITE-PAPER ACTION AREAS

The quality of economic governance affects the four action areas of the White Paper in many ways, both directly and indirectly, mainly through decisions that influence the allocation of public expenditures. This section provides some illustrative examples of these interrelationships. The basic message is that good economic governance requires a major reallocation of public expenditures, both between and within sectors, to target poor rural households more directly and effectively.

A. Rules of Trade and Market Access

Activities affecting the rules of trade, such as those related to the Free Trade Area of the Americas (FTAA), financial regulation, and contracts enforcement, will need to be pursued with a conscious identification of their impact on different groups of poor people. For example, if agricultural liberalization under the FTAA is likely to affect some poor farmers adversely, as was the case in Mexico after the North American Free Trade Agreement (NAFTA) came into effect, then assistance programs for the affected groups need to be designed in advance so that they can effectively mitigate these effects through programs of compensation (poverty alleviation) and, more importantly, programs that assist poor rural households to develop alternative, more permanent, and better sources of income (poverty reduction). In the area of financial regulation, actions to bring rural microfinance institutions into the regulatory framework are especially important for creating self-sustaining financial institutions with a strong capacity for expansion. With respect to contracts enforcement, the very long time frame required for effective judicial reform in most countries means that opportunities for utilizing alternative dispute-settlement mechanisms should be explored.

More equitable access by the rural poor to markets, both domestic and external, will depend to a large extent on the construction or improvement to all-weather standards of farm-to-market roads in poor areas. The executive and legislative branches of government must make conscious decisions to target investments in rural roads to geographic areas where the incidence of poverty is high. At the same time, the scarcity of available resources means that not all poor areas can receive such investments. Other things being equal, priority should be given to poor areas with the greatest agricultural potential.

Access to markets can also be facilitated by providing better market information to poor farmers, whose lack of education and geographic isolation make it difficult for them to keep up-to-date on price and other conditions in the markets for the commodities they produce. Good economic governance requires assistance to help level the playing field through radio programs and other media channels that convey current market information to poor households in ways that can be easily absorbed. Providing more sophisticated information to the rural poor on external markets (especially on standards, certification systems, and requirements for niche markets) will require working through NGOs and private enterprises.

B. Science and Technology

Many of the potential benefits to poor rural households of advances in science and technology require basic literacy and numeracy for their application to be effective. Investments in basic, secondary, technical, and adult education in poor rural areas thus facilitate the adoption by poor farmers of more efficient farming techniques and technologies and improve the access by members of poor rural households to off-farm jobs paying higher wages. Targeted investments in rural electrification and irrigation also increase the ability of poor rural households to benefit from advances in science and technology. Improved access to credit by poor rural households--a shared responsibility of the public and private sector--will make it easier for these households to purchase modern agricultural inputs, including those that are becoming available through advances in biotechnology. Greater investments in research on crops of particular importance to the poor, and extension services better targeted to poor farmers, are other ways to reorient public expenditures toward poverty reduction.

C. Access to Assets

The asset of the rural poor with the greatest potential for bringing them out of poverty--their own human capital--has already been discussed in several different contexts. The need for improved access to credit has also been mentioned, as has access to infrastructure assets such as roads, electric power, and irrigation systems.

Another important asset, obvious in the rural context, is land. While the potential of land redistribution to lift rural households out of poverty is limited by the simple arithmetic of available land and the numbers of poor farm households, and education and training is a far more promising route for rural poverty reduction (de Janvry and Sadoulet 2001:4), the potential stronger rural land markets for reducing poverty should not be overlooked. Good governance requires that investments be made to strengthen cadastre and land-registry systems, and to provide more equitable judicial mechanisms for dispute resolution, especially through alternative dispute-resolution systems. Providing secure land titles can improve poor farmers' access to formal credit, although the literature suggests that the relationship between secure land titles and access to formal credit is not as close as might be thought. However, recent studies of land-titling programs in Honduras and Paraguay found positive impacts on investment demand, credit supply, and the income levels of farm households (Wodon 2000:64).

D. Vulnerability Management

The income levels and living standards of the rural poor are highly vulnerable to normal annual climatic variations, natural disasters, and wide fluctuations in the prices of commodities produced for local and external markets. This vulnerability is exacerbated by the vicious circle between rural poverty and environmental deterioration, whose effects were evident in the pattern of damages and destruction caused by Hurricane Mitch in Central America in 1998.

Good economic governance in the face of this situation requires a coherent national strategy for disaster prevention and mitigation, as well as the establishment of an appropriate legal and institutional framework for implementing the strategy. Such a framework should be based on strong institutions at the local level that ensure widespread participation, including that of poor people, and close cooperation between the public and private sectors.

With respect to price fluctuations and other types of economic vulnerability, policy-makers need to keep in mind that agricultural productivity increases and an eventual liberalization of world trade in agriculture will accelerate the "push" of poor people in LAC countries out of farming activities. Sound macroeconomic and microeconomic policies are thus necessary to stimulate investment and job creation in non-agricultural activities and to prevent rural poverty from simply being converted into urban poverty.

V. ROLES OF THE PUBLIC AND PRIVATE SECTORS

A. Macroeconomic Policies

The broad definition of economic governance adopted in this paper implies a strong role for government in a variety of areas. One of these is the maintenance of sound macroeconomic policies. Although this paper will not enter into a discussion of specific policy instruments in this area, it is worth recalling that sound macroeconomic policies must be maintained reasonably consistently for at least three or four consecutive years in order to provide investors a reasonable degree of confidence that sound management of the economy by public-sector institutions will be sustained.

It is also important to bear in mind that assuring equitable access by the poor to productive assets will require adequate fiscal revenues. In the context of the need to maintain fiscal discipline, these fiscal requirements generally will have to be met not only by reallocating public expenditures but also by improving tax administration and/or raising tax rates. If tax-rate increases are deemed necessary, they should be applied to taxes that do not discourage private investment.

B. Other Public-Sector Actions

Many important economic-governance actions have already been discussed in the previous sections of this paper. This section provides a brief summary of these and other actions, as time and space considerations do not permit an extended discussion. These actions are grouped into four broad categories: (1) stimulating private investment, (2) promoting competitive behavior and protecting consumers, (3) providing equitable access to public services, and (4) strengthening social policy.

1. Stimulating Private Investment

* Reducing the costs and time required for establishing businesses. The high costs to society of onerous business-registration requirements have been clearly demonstrated by research carried out by Hernando de Soto and his colleagues in Peru and other countries.

* Providing adequate protection of physical and intellectual property rights, through legal reforms and stronger, more equitable application of laws and regulations by a reformed judicial system. These reforms include measures to improve land-tenure security.

* Preserving the integrity of the financial system through vigorous application of international (Basle) standards of financial regulation. Aggressive and risky behavior by financial institutions can encourage business investment in the short and medium run; but over the long run a weak financial system will have negative effects on investment and economic growth, as demonstrated clearly by events in East Asia over the last five years. Even Japan, a highly developed country, has seen its economic growth halted for a decade or so by a weak financial system.

* Providing a legal framework to facilitate formal savings (and therefore investment) by poor people, e.g. by permitting microfinance institutions, cooperatives, and other such entities to mobilize savings and by bringing them within the purview of the regulatory authorities.

* Establishing and providing highly trained and motivated staff for "one-stop windows" for potential foreign investors, permitting them to complete at a single location all paperwork requirements for establishing local business operations.

* Establishing or strengthening laws and regulations that permit the privatization of public services such as telecommunications, electricity, ports, airports, roads, and water systems. Privatization is not a panacea for improving efficiency and service quality, but in the great majority of cases private entities have had a better track record than their public counterparts. In addition, many LAC governments are heavily indebted, making it difficult if not impossible for them to borrow the large sums needed to finance expansions and improvements in key services. Since many of these services cannot be provided in competitive markets, due to conditions of natural monopoly or small market size, the privatized services will need to be carefully regulated to prevent the exercise of monopoly power.

* Establishing an independent, impartial judicial system to give investors confidence that business disputes can be resolved in a fair manner, without large expenditures of time and money, including the payment of bribes. Since reform of civil and commercial law requires major cultural change in most LAC countries, it will be a long process. In the interim, opportunities to establish alternative dispute-resolution mechanisms should be explored.

* Implementing measures to improve the security of persons and property. An increase in crimes against persons and property will raise costs to businesses (e.g. more security personnel and security infrastructure; ransom payments, insurance payments) and deter investors. More effective police forces are needed to punish criminals and deter crime; but even more important are preventive measures, including better educational and employment opportunities for young people. While criminal-justice reforms can be regarded as being (almost) exclusively within the realm of democratic governance, preventive measures should be considered as the joint responsibility of policy-makers concerned with both democratic and economic governance.

2. Promoting Competitive Behavior and Protecting Consumers

* Requiring transparency in business and financial operations, e.g. through stronger and more timely public-disclosure requirements for corporations and financial institutions.

* Approving and implementing anti-monopoly legislation.

* Strengthening the regulation of natural monopolies.

* Enacting and enforcing consumer-protection legislation, including the establishment of grades and standards as well as labeling requirements for foods and medicines.

* Enacting and enforcing anti-corruption legislation, including strict legal requirements for government procurement.

3. Providing Equitable Access to Public Services

* Building or improving farm-to-market roads in areas with a high incidence of poverty but also with good agricultural potential.

* Extending rural electrification to more communities, thus increasing opportunities for agricultural production (e.g. through irrigation pumps), agricultural processing, and the provision of a variety of non-agricultural goods and services that can be produced in rural areas.

* Constructing irrigation systems that can be managed and maintained sustainably by local water-users' associations.

* Reorienting agricultural-research priorities to focus more on commodities produced by poor farmers.

* Targeting agricultural-extension services to focus on small-farmers and small-farmer cooperatives.

4. Strengthening Social Policies

* Increasing the availability and improving the quality of basic and secondary education, technical training, and adult education, so that rural residents can acquire the human capital they need to escape poverty.

* Adopting long-run strategies to provide access by all rural residents to a minimum package of basic health services. Better health status strengthens human capital by improving school attendance and performance and by making workers more productive.

* Improving the targeting of social-safety-net programs that seek to provide better nutrition, and improving incentive mechanisms linking food assistance to school attendance and use of health services.

* Accelerating the provision of potable-water and sanitation systems to poor communities lacking these services.

* Enacting and enforcing legislation that provides equality of opportunity for women, minority groups, persons with disabilities, and other groups whose opportunities have been limited by discriminatory practices.

C. Private-Sector Economic Governance

The term "governance" may at times seem awkward when applied to the private sector, but it is useful for focusing on proactive measures that businesses, NGOs, cooperatives and other groups can take to stimulate investment and employment, strengthen competitive behavior, and improve access to productive assets. These measures may be undertaken entirely within the private sector, but often they are most effective when done in cooperation with public-sector entities. Examples, some of which have already been mentioned, include:

* Establishing, through private initiative, industry-wide grades and standards, including standards for health and environmental certification, as well as codes of behavior governing labor relations and business ethics.

* Establishing on-the-job training programs that increase the human capital of the poor and enable businesses to raise wages in accordance with increased productivity.

* Establishing or supporting NGOs that promote sustainable microfinance institutions as well as various educational, health, and cultural and other programs that strengthen human capital.

* Improving opportunities for small farmers through contract-farming arrangements that provide guaranteed markets for crops meeting quality standards, technical assistance to help meet these standards, and credit to finance production.

* Utilizing private-sector extension services to transfer technology to small farmers.

* Seeking collaborative arrangements under which microenterprises can provide materials and services to medium- and large-scale businesses, and rural households can produce items (e.g. apparel) at home under the old "putting-out" system.

* Establishing joint public-private mechanisms to promote and stimulate tourism, commodity exports, and foreign investment. Tourism can be an especially important generator of rural employment and incomes in countries with significant ecotourism potential.

* Creating technically sound (not politicized) "social auditing" mechanisms to monitor the effectiveness, efficiency, and integrity of government operations.

* Devising strategies and programs, jointly with public-sector entities, to reduce criminal activity that raises business costs and deters investment, especially in specific locations such as industrial parks devoted to *maquila* production or major tourism areas.

* Strengthening small-farmer cooperatives (e.g. through assistance by NGOs) to increase these producers' bargaining power in the marketing of agricultural products.

VI. APPROPRIATE AND INAPPROPRIATE INTERVENTIONS

Experience in the LAC region and other developing countries has made clear what kinds of economic-governance interventions tend to be effective in sustainably improving rural prosperity. Other interventions have been shown to be clearly ineffective, although some of these continue to be funded or proposed. In most if not all cases, the appropriate interventions will be most effective when economic-governance decisions are made jointly by governments and representatives of private enterprise, NGOs, and other civil-society groups.

A. Appropriate Interventions

Apart from sound macroeconomic policies and other measures to stimulate overall GDP growth, recent experience in a number of LAC countries suggests that the following strategies and mechanisms, among others, have been effective ways to improve economic governance in rural areas, and can be replicated elsewhere in the LAC region:

* **Education**, ideally through the secondary level, and **on-the-job-training**. Investments in basic and secondary education are probably the most important measures for enabling the rural poor to escape poverty over the long run. Good economic governance requires that tough decisions be made not only to increase funding for education and training but also to improve their quality. Quantitative analysis of Mexico by de Janvry and Sadoulet (2001:4,6) finds that human-capital variables are the most important set of factors explaining rural inequality. Education will prepare new workers mainly for higher-paying nonagricultural activities; but in Northeast Brazil, Ecuador, and Guatemala, literate farm workers and agroindustrial employees had significant wage increases following on-the-job training programs (Damiani 2000:8). Consultations between governments and other sectors of society are important for ensuring that the content and quality of education are responsive to the changing requirements of the marketplace. On-the-job training programs involve the private sector by definition; but they should also be an important component of governments' strategic planning for technical education, since they are often more cost-effective than school-based programs.

* **Market-driven systems approaches** to agricultural production and related activities that stress integration with the entire marketing chain. The FINTRAC/CDA program in Honduras has increased incomes and employment in rural areas, decreased post-harvest losses, and increased farmer purchases from microenterprises (FINTRAC 2001a and 2001b). The PRA project in Peru has produced similar results (Chemonics

2001). The long-run success of such programs will require the sustained availability of high-quality, specialized technical assistance in marketing for a number of years; but the payoffs of having the right people for these activities are high. While these interventions might appear to fall within the realm of private-sector economic governance, their effectiveness will depend to a large degree on the quality of supportive public-sector actions, including education and training and a number of the other interventions discussed below.

* **Secondary cities** as a focus for integrating farm-level and non-farm economic activities. In Honduras and Peru, enterprise development has been successfully stimulated through business service centers in selected cities. Again, this is an area where close cooperation between the public and private sectors is needed to improve investment climates at the local level. Greater opportunities for the exercise of local initiative should stimulate competition among regions, reduce an unhealthy dependence on central-government actions, and contribute positively to economic growth.[3] However, unless local governments have significant fiscal autonomy--most now depend too much on transfers from the central government--there are limits on how successful the secondary-cities model can be.

* **Cooperative efforts between the public and private sectors to promote, and jointly solve problems related to, agricultural, agro-industrial and other exports from rural areas**. Such efforts have benefited small farmers in Northeast Brazil, Ecuador, and Guatemala (Damiani 2000). Government decision-making in this area will be more effective when it is better targeted to overcoming specific obstacles identified by the private sector. Perhaps the classic example of the great potential of this model is South Korea in the 1960s. The Korean experience, however, is not easily transferable to LAC countries, where the political context is very different.

* **Contract-farming arrangements**, which have benefited small farmers in Guatemala, Honduras, and other LAC countries. While these arrangements have not always been sustained, the successful models suggest that contract farming is often a more efficient way of transferring technology to small farmers than traditional public-sector extension services. The fact that new crops and technologies associated with these programs have had spread effects to participant farmers' neighbors would seem to indicate that these contractual arrangements can have lasting benefits even if they are terminated because of changing market conditions, the high costs of supervising large numbers of small contracts, small-farmer problems in meeting quality standards, or other

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[3] The secondary-cities focus differs somewhat from the more ambitious regional-development focus proposed by de Janvry and Sadoulet (2001:11-12), which involves more formal, comprehensive planning activities whose effectiveness might be choked by administrative complexities. Nevertheless, their call for comprehensive regional development frameworks, with explicit poverty-reduction strategies and public-investment programs designed as magnets for attracting private investors, is appropriate for regions where planning and administrative skills are adequate and local political and business leaders are open to broad-based models of development. Elsewhere, the more limited secondary-cities focus would appear to be a better option, although its evolution into a regional-development focus is a worthy long-term goal.

factors.[4] Damiani (2000:7) suggests that governments might make contract farming more attractive by improving the legal framework and providing credit to small farmers.

* **Social investment funds**, established in most Latin American countries during the 1990s. These funds, which receive significant funding from external donors, generally have been more effective mechanisms for implementing small infrastructure projects--especially schools, health facilities, and water and sanitation systems--than the respective line ministries or government agencies traditionally responsible for these investments. Quantitative evidence from Honduras suggests that consultation with the rural poor prior to implementation increases the probability of their participation in projects; and their participation in the implementation process increases the probability that they will use the facilities once they are completed (Wodon 2000:118-122). Nevertheless, a long-term concern with these funds is that they can provide governments excuses to delay reforming their line ministries and autonomous agencies.

* **Investments in physical infrastructure** (electric power, irrigation, roads), which were deemed crucial to the success of NTAE programs in Northeast Brazil, Ecuador, and Guatemala (Damiani 2000:4). In Mexico, de Janvry and Sadoulet (2001:8) find that "ejidos connected by paved roads have a lower incidence of poverty. In the Progresa communities, village infrastructure (communities connected by federal or state roads) reduces the incidence of poverty." Good governance within a framework of broad-based economic growth and poverty reduction calls for more effective targeting of public infrastructure investments to poor communities. But since resources are scarce, priority should be given to communities with the greatest agricultural and other economic potential.

* **Decentralization of public services to local governments, combined with greater participation by the rural poor in decision-making**. Decentralization has had positive effects on poverty reduction in Bolivia and Mexico (de Janvry and Sadoulet 2001:12). However, when decentralization is undertaken without adequate training for local governments and the NGOs working with them, failure has been common (de Janvry and Sadoulet 2001:12; Echeverría 1998:28).

* **Microfinance programs** operating on sound banking principles and subject to review by national regulatory authorities (e.g. BancoSol in Bolivia). Programs of this nature can be effective mechanisms for mobilizing the savings of the rural poor and financing their investments in productive activities. Many LAC countries need legal reforms to permit microfinance programs to develop along these lines. At the same time, the importance of microenterprises in the development process needs to be demythologized. Microenterprises are more appropriately viewed as cabooses rather than engines of development. In other words, their overall growth will depend mainly on the performance of the macroeconomy.

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[4] For a brief discussion of the mixed experience of contract farming in Latin American countries, see Carter el al. (1995:11-13) and Damiani (2000:5-7).

* **Provision of environmental services** (e.g. soil and water conservation, preservation of biodiversity, forest protection), for which rural residents would receive fees (e.g. carbon sequestration payments). Limited experience with these new activities suggests that they may be important future sources of income for the rural poor. NGOs can play a major role in arranging such services and helping rural communities implement them. But governments, too, have an important role to play by establishing appropriate legal and institutional frameworks.

B. Inappropriate Interventions

* **Integrated rural development programs**. These programs generally have been high-cost and have been bogged down by complex administrative structures involving large numbers of government agencies, all concerned with turf-protection issues. Strategically, the same goals can be met better through **coordinated** public-sector interventions in targeted rural areas where the incidence of poverty is high. This coordination can be done without creating and staffing a formal institution; but it should include participation by the rural poor in the planning, implementation, and monitoring of programs.

* **Subsidized credit**. Farmers of all sizes will always want subsidized credit, and some NGOs are still wedded to these programs. But the record is clear that they are both financially unsustainable and not successful in producing sustained benefits for small farmers. Many public-sector agricultural development banks (most now mercifully closed or substantially scaled down) also provided most of their funds to medium- and large-scale farmers and farm-related businesses. Lack of access to formal credit (due partly to lack of secure land titles) is more of a problem for small farmers than market interest rates.

* **Fiscal incentives for investments in rural areas**. These programs, to the extent that they indeed lure businesses to rural areas, result in misallocations of productive resources and deprive the government of needed fiscal revenues. Often, however, they have had few takers. A much better strategy for attracting businesses to rural areas is to improve the availability and reliability of infrastructure (electricity, water, roads, etc.) and the quality of human resources.

* **Price and marketing controls**. Price and marketing controls, now largely abandoned in most LAC countries, discourage production while encouraging hoarding and contraband activities, especially along the borders with other countries. Often applied to basic grains, price controls penalized the very poorest groups in society (small farmers) while benefiting the better-off urban poor as well as urban middle- and upper-income groups.

* **Government housing programs**. Public investments in housing are one of the least productive activities undertaken by governments. They can eat up enormous sums of money that would be much better spent on programs in education, health, and

nutrition. They have been subject to significant amounts of corruption, and most of the beneficiaries have been middle-class households and those close to middle-class status. If any public monies are to be spent in this area, they should be for small home-improvement loans, carefully targeted to low-income households. Medium- to long-term loans could be dollarized to keep real (market) interest rates relatively low, although borrowers would have to bear exchange-rate risks.

* **Traditional public-works programs**. These "workfare" programs, used in some LAC countries during periods of recession, have been relatively expensive, costing $3 or more to provide $1 in income to beneficiaries (Wodon 2000:94-97). Moreover, some of them are not well targeted.

VII. PROGRAM AND OPERATIONAL LINKAGES

The broad concept of economic governance adopted in this paper makes clear that the creation of rural prosperity and reduction of rural poverty requires much more than the traditional tools of macroeconomic and microeconomic policy. Reliable policies in these areas are necessary to stimulate investment, but private investors also need an improved judicial system, relatively free of corruption and arbitrary applications of the law; security of persons and property; a well-educated and -trained labor force; and reliable infrastructure.

A. Within USAID

The economic aspects of USAID/LAC's rural-prosperity activities should be closely coordinated with activities in a variety of other areas, including democratic development, the administration of justice, education, health, environmental protection, and disaster prevention and mitigation. The previous sections have made clear that these are all essential elements of good economic governance. Examples of such coordination include:

* Joint programming of economic-policy and economic-growth activities with those in the areas of education and training, to ensure that the latter provide the cognitive, technical, managerial, and administrative skills that LAC countries need to become more competitive in external markets;

* Joint programming of tax-reform measures that seek to strengthen fiscal management and stimulate private investment, and DG (democracy and governance) activities that seek to reduce corruption and tax evasion;

* Joint programming of activities to stimulate economic growth of secondary cities and their hinterlands, and DG activities that seek to strengthen municipal governments; and

* Joint programming of job-training programs and DG activities in the area of crime prevention, to provide productive employment opportunities to young people at risk of engaging in criminal behavior.

At a broader level of USAID (and overall USG) programming, linkages will need to be developed between LAC's rural prosperity strategy and activities such as:

* USAID's new worldwide agricultural strategy, being developed by G/EGAD;
* The Andean Regional Program;
* The proposed Partnership for Prosperity for Mexico and Central America, which gives major emphasis to both agriculture and trade facilitation, and which USAID expects to implement in late FY2002 or early FY2003; and
* The Free Trade Area of the Americas (FTAA).

B. FTAA

Much of the agricultural potential of the LAC region lies in the production of nontraditional agricultural exports (NTAEs) for the U.S., European, and other markets. Many NTAEs can be produced efficiently by small farmers, especially those who are functionally literate, and new NTAE production on large farms will create many jobs for farm workers. Additional employment will be created in processing and packaging plants, input-supply and marketing operations, and the provision of a variety of services. LAC countries thus have considerable interest in the outcome of FTAA negotiations on liberalization of agricultural trade.

While USAID obviously cannot become an advocate for the LAC countries with respect to trade negotiations on specific commodities, it should continue to assist LAC countries in their general preparations for the FTAA, as liberalized trade will benefit the United States as well as the rest of the hemisphere. Apart from continuing support for regional trade-capacity-building programs in Central America (PROALCA) and the Caribbean, USAID might consider a similar program for the Andean region.

Assistance to the LAC countries in preparing for the FTAA will have the indirect benefit of strengthening their participation in the new round of trade negotiations launched, however tentatively, at the meetings of the World Trade Organization (WTO) in Doha, Qatar in November 2001.

C. Other Donors and External Organizations

The international financial institutions, particularly the World Bank and the Inter-American Development Bank (IDB), can complement the USAID/LAC rural prosperity strategy by increasing their lending for rural infrastructure, especially roads, electric power, and irrigation systems, projects that USAID generally finds too large to finance in the LAC region. They can also continue to support modernization-of-the-state and other structural-reform activities. Donor governments and NGOs can complement USAID activities through programs to strengthen local governments and civil-society organizations, promote democratic development, protect the environment, and improve human-capital assets.

D. Plan Puebla-Panamá

USAID/LAC's rural prosperity strategy will also need to be coordinated with the Plan Puebla-Panamá, an initiative of Mexico's president, Vicente Fox, which encompasses the poor, southern states of his own country and the countries of the Central American isthmus.

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